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Re: Financial Accounting Standards Board
Proposal: Principles-Based Approach to U.S. Standard Setting
File Reference No. 1125-001

Dear Board Members,

I have studied the above-referenced proposal and would like to comment on my belief as to its potential impact on the quality and transparency of U.S. financial reporting. Also implicit in my comments is my view of the ability of auditors to adjust to this approach. Finally, I provide some comments about the feasibility of the true and fair value override. Of course, the opinions expressed herein are my own.

First, it appears that one of the main objectives of the principles-based approach is to reduce the opportunity for financial and accounting engineering that might result in diminished transparency. Importantly, it is believed that auditors are unable to curtail this engineering as long as the letter of the accounting rule has been complied with. I have heard the Enron case cited as an example of this dilemma under the current system.

I assume that the other objectives of the proposal (e.g., to increase consistency with International Financial Reporting Standards and to reduce standard setting time and implementation costs) have merit but that these objectives are secondary to the effect of the approach on transparency. Thus, if a principles-based approach were to significantly increase the opportunity for earnings management or fraud then the benefits from these other objectives would not outweigh the cost of reduced transparency.

My concern is that the principles-based approach would not make it easier for auditors to prevent management from using accounting manipulation to obscure economic reality and that it may make it more difficult. At a minimum, this would lead to more earnings management. In the extreme, the probability for financial statement fraud would increase. Fraud is generally considered to be a direct function of managements' incentives and opportunities for fraud, mediated by their attitude toward fraud. In my view, the principles-based approach increases management's opportunities for fraud. Below I explain why I believe this to be the case.

I refer to the Enron case to illustrate my point. Under the current approach, Enron went to great lengths to engineer their accounting and remove debt from their balance sheet. To do so required them to hire experts (e.g., investment bankers, lawyers and accountants) because the opportunities for fraud were not easily forthcoming.

The argument goes that the rules-based approach allowed Enron to obscure economic reality as Arthur Andersen was compelled to agree that what Enron was doing was within the letter of the law. However, imagine a principles-based approach where several potential implementation options for an accounting

principle co-exist. Under that system, Enron could simply develop their most favorable interpretation of the principle and provide their rationale to Andersen. The question is: Would Andersen be more or less likely to go along with the Enron's financial engineering under the principles-based approach?

Under this scenario, I believe Andersen would have no more reason to disagree with Enron than they had under the current system and they might have less reason. Importantly, many other implementation options would exist. Because no rules would eliminate these other, reasonable, options, each would be difficult for an auditor to disagree with.

While under the current system, an auditor may reason that if the letter of the law is in compliance they cannot be accused of abetting a fraud, under the proposed system, they are likely to reason that if the client has some rationale behind their implementation of the principle they cannot be accused of abetting a fraud. Thus, financial and accounting engineering will not decrease but will simply become easier to engage in and will result in more variability and less comparability.

In closing, I offer a few thoughts related to earnings management and the true and fair value override. First, I agree with the view of Mr. Sprouse (quoted in the proposal) that economic volatility should be revealed to the market. In my opinion, volatility of earnings is a key piece of information that is concealed from investors by accounting manipulations that attempt to smooth earnings (i.e. earnings management). Thus, any proposal that allows more opportunity to use accounting discretion to obscure volatility will reduce transparency. I see the principles-based approach as leading to not only more fraud but also more opportunity for earnings management and therefore less transparency in the financial reporting system.

Second, I do not believe the true and fair value override will allow auditors the ability to exercise authority in eliminating fraud. My reason for this is because auditors believe they need something concrete to defend their positions in court. Thus, an auditor trying to defend a position that is not prescribed in the standards will find it impossible to convince a jury that they should override an accepted standard while the other side can show the jury that the standard specified the treatment that the auditor overrode.

I believe empirical research on this topic could be used to support or refute these and others' opinions and encourage the Board to sponsor such research.

Please feel free to contact me if you have questions.

Sincerely,

Mark F. Zimbelman, Ph.D., CPA